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SUBJECT: AN INSIDER'S LOOK AT RUSSIA'S COMMERCIAL REAL ESTATE

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Summary

[1](#)1. (SBU) We have reported extensively on the residential real estate sector. Last week Econoffs returned to Cushman & Wakefield to gain a better understanding of the flip side of the coin: commercial real estate. Denis Sokolov, Head of Research, said the commercial real estate market is "hot," especially in Moscow, which has the world's second most expensive office space. He said "mixed-use" development projects, which combine residential, office and retail space, are an upcoming trend, that Russia's regions are an even more attractive future market for commercial real estate than Moscow. Finally, he noted that the commercial sector does take resources from residential housing and is therefore partly to blame for the current shortage in adequate housing. End summary.

Moscow: the World's Second Most Expensive Offices

[1](#)2. (SBU) Sokolov told us that Cushman & Wakefield's main source of revenue is commercial real estate. They provide a menu of services to developers up to and including management of commercial real estate in Russia. The commercial real estate sector in Russia, especially Moscow, is definitely "hot," according to Sokolov. This includes all three primary categories of property: office, retail and industrial (i.e. warehouse). Sokolov said that buildings of the highest quality in terms of location, design, building standards and efficiency -- referred to as "Class A" property -- are in the highest demand across all three categories.

[1](#)3. (SBU) Sokolov told us that office rental rates for Class A property in Moscow are the second most expensive in the world after London's West End. He said that the rental price averages more than USD 1,000 per square meter in Moscow and USD 2,500 in the city's center. According to Sokolov, high rental rates are driven by developers taking advantage of high demand and a heretofore weak supply response. He explained that before construction is complete, a developer announces a rental rate that is higher than the prevailing market rate -- speculating that rental rates will continue to climb. While new office space may not rent as quickly, Sokolov said developers prefer a vacancy periods in return for the prospect of a higher rental price. In that regard, Sokolov said vacancy rates are high, averaging 10 percent in Moscow compared to only 3-5 percent London.

[1](#)4. (SBU) Commercial real estate for industrial use in the Moscow area, which Sokolov said primarily consists of warehouses that are used by large retailers, is also in high demand. Rental rates average USD 140 per square meter in Russia compared to only USD 80 in Europe. He noted that current delays in warehouse construction in Moscow (averaging 9-12 months) were responsible for pushing up the city's rental rates from USD 125-140 to USD 135-145 per square

meter over the last quarter (4Q07 to 1Q08).

Mixed-Use Projects: an Emerging Trend

15. (SBU) "Mixed-use" projects are a growing trend in commercial real estate, according to Sokolov. These projects combine residential, retail and office development into one project. The idea is to create a balanced community that while perhaps located outside a city center, is still self-sufficient. Sokolov said most "mixed-use" projects are still in the preparation stage, but that plans are underway for several major projects: "A-101," located just outside of Moscow; "Big City," also outside Moscow; the Domodedovo "community" near the airport; and a mixed use project in Sochi, site of the 2014 Winter Olympics.

Economic Growth in Regions Driving Development

16. (SBU) Sokolov said that Russia's regions hold even more potential than the Moscow area for future growth of both retail and office real estate. He said that strong growth in retail sales has resulted from rising incomes. This in turn has led to a huge nationwide demand for more retail outlets. He explained that Moscow's market for retail real estate -- particularly large shopping centers -- has nearly stabilized. However, other large cities located in the regions lack quality space and have become prime locations for retail development. Sokolov said retail space in the regions has a vacancy rate of less than one percent and that rental rates are rising rapidly.

17. (SBU) Sokolov told us that retailers were changing their preferences on what type of property they want, in Moscow but especially in the regions. With the emergence of foreign chains, such as Turkey's Metro and Germany's Cash 'n Carry, Russian shoppers preferences have changed from stand-alone shops to larger shopping centers that provide more consumer choices. He predicted that in a few years, people living in the regions would become accustomed to traveling relatively long distances to do their shopping and that larger shopping complexes would become much more common.

Effects on Residential Housing Sector

18. (SBU) Sokolov told us that the commercial real estate sector was partly to blame for the lack of an adequate supply of residential housing. He said that scarce resources, such labor and construction materials, will naturally follow the money -- which currently means commercial developers. However, Sokolov added that the lack of land for residential construction is a different matter, as some land plots are more suited for particular uses and thus competition between the residential and commercial real estate sectors in this regard was not a contributing factor.